

## Module J

### IRC § 146 - Volume Cap

#### Overview

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##### Introduction

Modules E through I discussed qualified private activity bonds. According to IRC § 141(e), to be considered a “qualified bond,” an obligation must meet the:

- applicable specific requirements of IRC §§ 142 through 145,
- applicable requirements of IRC § 146, AND
- applicable requirements of IRC § 147.

Once an issue has met the requirements of the specific section under which it is described (IRC §§ 142 through 145), the issue must still meet the volume cap requirements of IRC § 146, if applicable, AND comply with the applicable provisions of IRC § 147.

Module J discusses the volume cap, while Module K covers the requirements of IRC § 147.

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##### Objectives

At the end of this module, you will be able to:

- Define and differentiate between the terms “volume cap” and “state ceiling.”
  - Identify the types of bonds that are subject to the volume cap.
  - Explain how the volume cap is computed.
  - State the consequences of exceeding the volume cap.
  - Determine if a proper election has been made to carry forward unused volume cap.
  - Describe procedures that can be used to verify if the bonds have met the volume cap requirements.
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## Overview, Continued

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### Current Regulations

Current regulations (Treas. Reg. Sections 1.103(n)-1T through -7T) for the volume cap still reflect the provisions of section 103(n) of the 1954 Code, and have NOT been updated to incorporate changes made by the TRA 1986.

Transitional rules relating to the volume cap are in Sections 1312(b)(3), 1313(a), 1313(b)(5), and 1315 of the TRA 1986.

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### What is the Volume Cap?

Generally, every state and US possession is limited to a maximum amount of tax exempt bonds that can be issued on an annual basis. This amount is based on the state's population and is computed annually. The amount allocated to each state is called the "state ceiling." The amount of the state ceiling is then allocated among the issuing authorities within a state. This allocation is called the issuing authority's volume cap.

According to IRC section 146(a), bonds issued in excess of an issuing authority's volume cap will not meet the requirements of IRC section 146, and therefore, may NOT be treated as tax exempt bonds.

Remember that only qualified private activity bonds are required to meet IRC section 146. Governmental bonds are not required to receive an allocation of the volume cap.

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### How does it work?

Borrowers contact prospective issuing authorities with project proposals. Issuing authorities approve projects and then allocate a portion of their volume cap to the bonds financing the project. A certification of this allocation will be included in the bond transcript.

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## Volume Cap, General Rules

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### State Ceiling

The state ceiling limits the amount of tax-exempt private activity bonds that can be issued annually in each state. According to IRC §§ 146(d)(1) and (2), **for calendar years after 2001**, this limit is equal to the greater of:

- \$225 million, or
- \$75 multiplied by the state's population.

For bonds issued after calendar year 2002 the amounts will be adjusted for cost-of-living increase under §1(f)(3) for such calendar year. If any increase is not a multiple of \$5 (\$5,000 in the case of the dollar amount), such increase shall be rounded to the nearest multiple thereof.

These inflation adjustments are published in a revenue procedure issued prior to the beginning of each year. For example, the adjustments for the calendar year 2005 were published in Rev. Proc. 2004-71, 2004-50 IRB 970. These adjustments resulted in the following limits for 2005:

- \$80 multiplied by the State population, or
  - \$239,180,000.
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### State population estimates

State population estimates used in the calculation of the state ceiling are published by the Office of the Associate Chief Counsel each year via a notice. The notice, entitled "200X Calendar Year Resident Population Estimates" is usually published very early in the year

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### Allocation of State Ceiling

Each state's ceiling is allocated among state issuers and local issuers as follows:

- 50 percent among the state and its agencies, AND
- 50 percent among local issuers and authorities within the state on the basis of relative populations.

(See sections 146(b) and (c).)

However, according to IRC § 146(e), in certain circumstances, a state's legislature may provide its own allocation formula for allocating its bonds.

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## Volume Cap, General Rules, Continued

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### Example 4

In 2005, State A's population consists of 10 million residents. The largest cities are City A with two million residents and City B with three million residents. The rest of the population resides in other smaller cities.

State A's ceiling is equal to the greater of:

- \$239,180,000, OR
- \$80 multiplied by the total population (80 x 10,000,000=\$800M)

Since \$800M exceeds \$239,180,000, State A's ceiling equals \$800M

The state issuers and local issuers are each allocated \$400M. Since City A (population \$2M) and City B (population \$3M) are considered local issuers, they would compute their allocation as follows:

CITY A:  $2M/10M = .20 \times \$400M = \$80M$

CITY B:  $3M/10M = .30 \times \$400M = \$120M$

The \$800M ceiling would be allocated as follows:

All State Issuers	\$400M	50%	
City A	80	10%	} 50%
City B	120	15%	
Other issuers	200	25%	
Total	\$800M	100%	

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## Volume Cap, General Rules, Continued

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### **Definition of the Volume Cap**

The “volume cap” for any issuing authority is the maximum amount of tax-exempt private activity bonds that may be issued during the calendar year. For purposes of the volume cap, issuing authorities of each state are divided into two groups:

- the State and all of its authorized agencies, AND
- all other issuing authorities.

Therefore, there are many volume caps within each state. If any bond added to the amount of tax-exempt private activity bonds previously issued in that calendar year exceeds that issuer’s volume cap, that issue is taxable.

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### **Special Rules regarding Computation of Volume Cap**

IRC § 146(d)(3) provides special rules for allocations to constitutional home rule cities.

IRC § 146(d)(4) provides a formula for certain possessions of the United States, which allows them to base their volume cap on the cap for the state with the lowest population.

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### **Location of Bond financed Facility**

Generally, no portion of the state ceiling may be allocated to bonds the proceeds of which will be used to finance a facility located outside of the state.

(See IRC § 146(k) for specific exceptions.)

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## Bonds Subject to the Volume Cap

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**Only Certain  
Private Activity  
Bonds are  
Subject to the  
Volume Cap**

IRC section 146(g) provides that the volume cap applies generally to all qualified private activity bonds issued after August 15, 1986, including qualified enterprise zone facility bonds, except for the following:

- any qualified veterans' mortgage bond,
- any qualified 501(c)(3) bond,
- bonds used for airports, docks and wharves, environmental enhancements of hydroelectric generation facilities, and qualified public educational facilities (IRC §§ 142(a)(1),(2), (12) or (13)),
- 100 percent of any high-speed intercity rail facility bond (IRC § 142(a)(11)), IF OWNED BY A GOVERNMENTAL UNIT, (beginning January 1, 1994) AND
- 75 percent of any high-speed intercity rail facility bond (IRC § 142(a)(11)), IF OWNED BY OTHER THAN A GOVERNMENTAL UNIT.
- any qualified New York Liberty bond (IRC § 1400L (d)(5)(A)).

IRC § 146(h)(1) provides an additional exception for any qualified private activity bond used for solid waste disposal facilities (IRC § 142(a)(6), if all of the property to be financed is OWNED BY A GOVERNMENTAL UNIT.

IRC § 146(h)(2) provides the rules for determination of governmental ownership for purposes of IRC § 146(h)(1).

IRC § 146(f)(3)(A) provides that bonds issued pursuant to a valid carryforward election and within 3 years of the year in which the carry-forward closes shall not be included in the volume cap for the calendar year in which the bonds are issued.

IRC § 7871(c)((3)(iii) provides an exception for bonds issued by Indian tribal governments if at least 95 percent of the net proceeds are used for a manufacturing facility and certain other requirements are met.

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## Bonds Subject to the Volume Cap, Continued

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### **Bonds Which Refund Post-1985 Bonds**

Generally, IRC § 146(i) provides that current refundings of post-1985 bonds are not subject to the volume cap, as long as the principal amount of the refunding bonds is not greater than the outstanding principal amount of the refunded bond. Additional rules apply for qualified mortgage and student loan bonds.

Advance refundings of post-1985 governmental bonds and qualified 501(c)(3) bonds are subject to the volume cap only if the provisions of IRC § 141(b)(5) apply or would have applied if the section applied to the issue. (See IRC § 146(i)(5) and 146(m)(2)).

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### **Bonds Which Refund Pre-1986 Bonds**

Section 1313(a)(1) of the TRA 1986 provides that current refundings of pre-1986 bonds will not be subject to the provisions of IRC § 146 if:

- the amount of the refunding bond does not exceed the outstanding amount of the refunded bond, AND
- the average maturity of the issue of which the refunding bond is a part does not exceed 120 percent of the average reasonably expected economic life of the facilities being financed with the proceeds of such issue, OR
- the refunding bond has a maturity date not later than the date which is 17 years after the date on which the qualified bond was issued.

Section 1313(b)(5) of the TRA 1986 provides generally, that certain advance refundings of pre-1986 bonds are subject to the provisions of IRC § 146 to the extent of the nongovernmental use of the issue, if more than five percent of the net proceeds of the refunded bonds were used for output projects.

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### **Mortgage Credit Certificates**

IRC § 146(n) provides that the volume cap is reduced for certain mortgage credit certificates.

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## Bonds Subject to the Volume Cap, Continued

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### Co-ordination with IRC § 141(b)(5)

IRC § 141(b)(5) provides that a governmental bond will be treated as a private activity bond if:

- the “nonqualified amount” exceeds \$15 million, but is less than the amount needed to meet any of the private activity bond tests, AND
- the issuer does not allocate a portion of its volume cap to the issue in an amount equal to the excess of such nonqualified amount over \$15 million.

IRC § 141(b)(8) provides that the “nonqualified amount” is equal to the LESSER OF:

- the proceeds of the issue to be used for ANY private business use, OR
- the proceeds of the issue with respect to which there are payments (or property or borrowed money) described in IRC § 141(b)(2).

Note that this nonqualified amount must be less than the:

- 5 percent needed to satisfy the disproportionate use and/or payment tests, OR
  - 10 percent needed to satisfy the private business tests.
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### Example 1

County B issues governmental bonds in the principal amount of \$300M on June 1, 2005. The bonds are used to construct an office building. A for-profit entity enters into a long-term lease for 7% (\$21M) of the building. The lease payments accounted for 7% (\$21M) of the debt service.

IRC § 141(b)(5) provides that \$6M (only the EXCESS over \$15M) of these bonds must be allocated to the volume cap. (\$21M-15M)

If this \$6M is not properly allocated, then the **entire** bond issue would be considered to be taxable private activity bonds. (The issue could NOT be qualified private activity bonds, because the section 146 requirements would not be met.)

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## Bonds Subject to the Volume Cap, Continued

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**Example 2** County E issues bonds in the principal amount of \$200M on June 1, 2005. On the issuance date, County E reasonably expects to use 100 percent of the bond-financed facility for its own use. In May 2006, County E leases 8.5 percent of the facility to Corporation X, a for-profit entity. The lease payments (\$17M) will be used to pay 8.5 percent of the debt service on the bonds. There has been a deliberate action and change of use, but not enough to cause the bonds to meet the private business tests. However, \$2M of the bond proceeds should have been allocated to the volume cap. Section 141(b)(5) requires that the bonds be treated as private activity bonds. However, Rev. Proc. 97-15 or the remedial action provisions of Treas. Reg. § 1.141-12 may be applied. (Note, however, that these provisions are not applicable to issues discovered during an examination.)

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**Exception for Use by a 501(c)(3) Organization** IRC section 141(b)(9) provides an exception for use by a 501(c)(3) organization if the portion of the proceeds of a governmental bond used by the 501(c)(3) organization would be treated as a qualified 501(c)(3) bond if the issuer elects to treat such portion as a qualified 501(c)(3) bond.

For example, if Corporation X in Example 2 was a 501(c)(3) organization, the amount of proceeds allocated to the use by the 501(c)(3) organization would not be considered private business use for purposes of IRC section 141(b)(5) (or for any part of section 141(b) or (c)). This assumes that the use of proceeds would meet all of the requirements of a qualified 501(c)(3) bond, and the issuer elected to treat it as such.

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**Applicability to Qualified 501(c)(3) Bonds** IRC section 141(b)(5) may also apply to qualified 501(c)(3) bonds.

Assume that County E issued IRC section 145 bonds in the principal amount of \$400M. The proceeds of the bonds are loaned to Hospital, a 501(c)(3) organization. Hospital leases 4.0 percent of the facility to Corporation X, a for profit entity. The lease payments (\$16M) will be used to pay 4.0 percent of the debt service on the bonds. Although the private use is less than 5 percent of the net proceeds of the bonds, more than \$15M of the proceeds are used in private use. Under section 141(b)(5), County E should have obtained volume cap for \$1M (\$16M-\$15M) of the bonds.

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## Bonds Subject to the Volume Cap, Continued

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**Reporting  
Requirements**

Issuers of qualified private activity bonds are required to indicate the amount of volume cap allocated to the issuer on Form 8038, Part VIII, line 42.

Issuers are required to indicate the amount of a governmental issue allocated to the volume cap on Form 8038-G, Part VI, line 35.

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## Elective Carry-forward of Unused Volume Cap for Specified Purpose

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**General Rule** IRC § 146(f) permits an issuing authority to elect to carry forward any unused volume cap for three years, however only for certain purposes.

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**Specific Purposes Permitted** According to IRC § 146(f)(5), any excess volume cap must be assigned to one of the following purposes:

- qualified student loan bonds
- qualified mortgage bonds (or mortgage credit certificates),
- qualified redevelopment bonds,
- exempt facility bonds under section 142(a)
- enterprise zone facility bonds (Treas. Reg. § 1.1394-1(m)(3)).

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**Example 5** County B has been allocated \$50M of the state's volume limitation for 1998. During 1998, County B issues \$40M principal amount of bonds. County B has been contacted by Corporation X which plans to build a qualified residential rental project to be located in the County within the next 3 years. County B agrees that it will issue \$10M principal amount of bonds to finance the project. County B can elect to carry forward \$10M from 1998 for this purpose by filing Form 8328 by February 15, 1999.

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**Making the Election** This election is made by filing Form 8328 by the earlier of:

- February 15 following the year in which the unused amount arises, OR
- the date of issue of bonds issued pursuant to the carryforward elections.

See Rev. Proc 2005-30 which outlines the five requirements bond issuers must meet to receive an automatic six-month extension to make volume cap carryforward elections.

IRC § 146(f)(4) provides that the election, once made, is irrevocable.

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## **Elective Carry-forward of Unused Volume Cap for Specified Purpose, Continued**

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**Where to File Form 8328**

As of July 1998, these forms are filed with the Internal Revenue Service Center in Ogden, Utah. Prior to this time, these forms were filed with the Philadelphia Service Center.

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**Transitional Rules**

Section 1315 contains two exceptions under which bonds issued after August 16, 1986 are not subject to the provisions of IRC § 146.

Section 1315(b) provides that bonds issued pursuant to a carryforward election under section 103(n)(10) of the 1954 Code are not subject to IRC § 146 if:

- the election was made before November 1, 1985, and
- the provisions of Act section 1312(a) are met.

Section 1315(c) provides that IRC § 146 does not apply to bonds issued with respect to any facility or purpose specifically described in Section 1315(d) if the bonds would not have been subject to section 103(n) of the 1954 Code.

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## Summary of Module J

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### Review of Module J

IRC § 141(e) sets forth the requirements of qualified private activity bonds as:

- meeting the specific requirements of IRC §§ 142 through 145,
- meeting the requirements of IRC § 146, AND
- meeting the applicable requirements of each subsection of IRC § 147.

Modules E through I discussed the specific requirements of IRC §§ 142 through 145.

Module J discussed the volume cap requirements of IRC § 146. The most important points of this module are:

- Most qualified private activity bonds are subject to the volume cap, with some exceptions.
- Although governmental bonds and qualified 501(c)(3) bonds are not subject to the volume cap, if over \$15M of the proceeds are used in private use or disproportionate use, any amount in excess of \$15M will be subject to volume cap.
- Computation of each state's volume cap limitation and allocation are the responsibility of each state.
- Unused volume cap can be carried over for three years, as long as the carryover is for a specified purpose and the issuer is specified.

It is the agent's responsibility to verify that volume cap has been allocated if required.

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### Preview of Module K

Module K discusses other requirements of certain qualified private activity bonds that are contained in IRC § 147.

Qualified private activity bonds need to meet the appropriate subsections of IRC § 147 in order for the interest on the bonds to be tax-exempt.

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## Exercises

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### Exercise 1

The state ceiling for State Z for 2005 is \$200M. City M, a local issuer within the state, and State Z itself are authorized to issue private activity bonds. Under the allocation formula provided by State Z, City M has a volume cap of **\$50M**. The balance of the state ceiling (**\$150M**) is allocated to State Z.

On June 1, 2005, City M issues a **\$75M** issue of private activity bonds. On September 1, 2005, State Z issues a **\$150M** issue of private activity bonds.

**Question:** Based on these facts, are the bonds issued by City M described in IRC § 103(a)?

**Question:** What effect do City M's bonds have on State Z's \$150M issue?

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### Exercise 2

City K issues bonds in the principal amount of \$100M. City K uses \$50M for its own purposes and loans \$50M to a 501(c)(3) organization to build an animal shelter.

**Question:** What portion, if any, of these bonds is subject to the volume limitations?

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## Exercises, Continued

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### Exercise 3

In 1995, State Authority received an allocation of \$100M, which was 50% of the private activity volume cap reserved for the state under IRC § 146. At the end of the year, the Authority filed Form 8328, electing to carry forward \$80M of unused volume cap for the purpose of issuing qualified student loan bonds. In 1996, the State legislature passed legislation creating Corporation X to issue and oversee qualified student loan bonds. Corporation X wants to use State Authority's \$80M carryforward issue qualified student loan bonds in 1997.

**Question:** Can Corporation X use State Authority's carryforward to issue qualified student loan bonds?

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